

The Return of the Bear

Introduction -

There are occurrences in the business cycle when the consensus of my proprietary primary trend indicators find themselves within the confines of the bearish camp. Unfortunately, now seems to be one of those occasions. The last time the technical, economic, and monetary indicators aligned themselves in such a negative way was the turn of the millennium. Then, as now, for the benefit of my subscribers, and their valued clients and investments, I feel duty-bound to publish a [*Special Report*](#) setting out the arguments for the impending scene about to unfold.

In early 2000 it like the market was at, or close to, a secular or very long-term peak (albeit if not in absolute price terms, certainly in inflation-adjusted ones). Since then, the S&P has failed to take out its 2000 high; and deflated for commodity prices, actually came extremely close to a new (secular) bear market low in May of 2006.

Before setting out the current cycle's negative case though, we must first step back and re-examine the market's secular, or very long-term, technical position. It's also important to understand that while the position of the long-term indicators look extremely ominous from a primary trend point of view, they have not been confirmed with a negative 12-month moving average crossover by the S&P. *And until that happens, assume the primary uptrend is intact.*

At the end of June, the average is expected to be around 1255, which is about where the average was in mid-June when this report was completed. However, it requires a monthly closing price for a signal.

Martin J. Pring

June 17, 2006

Secular Trend in Stock Prices -

Stock prices have undergone a series of secular up and down trends since the mid-nineteenth century. These very long-term price movements can survive through several business cycles and have often taken the form of strong multi-year bull markets, such as the 1920's, 1980's, and 1990's. On the other hand, secular "bear" markets have been more subdued and often show up on the charts as multi-decade sideways trading ranges. When adjusted for inflation though, these "trading ranges" turn out to be major bear markets where the purchasing value of stocks has been decimated.

Peaks in optimism and troughs of pessimism establish secular inflection points. And what better way to measure this concept than price-earnings ratios? After all, when investors are willing to purchase stocks with a high valuation, they are obviously confident and optimistic. In these situations, prices have typically been moving up for a decade or so, which means that confidence is extremely high and carelessness takes over from sound money management principles. The only reason they literally give them away when valuations are in the basement is because they have little or no hope for the future. Bearing this in mind, Chart 1 shows Robert Shiller's Price-Earnings Ratio between the late nineteenth century and the turn of the millennium.

Using the P/E Ratio, there have been four peaks in sentiment since 1870. I chose those that developed in excess of 22.5, and labeled them with the numbers 1, 2, 3, and 4. These peaks developed around 1900, 1929, 1966, and 2000, respectively. Generally speaking, when crowd psychology reaches such an extreme (flagged by the high price-earnings numbers), it either takes a long time, considerable price erosion, or both, along with a total disgust with equities before the psychological pendulum can swing sufficiently in the opposite direction to lay the foundation for a new secular bull market. Troughs are signaled when the Ratio falls below 7.5; i.e., at times when the market offered exceptional values (they are labeled A, B, and D). C1 and C2 also offered timely long-term entry points. These

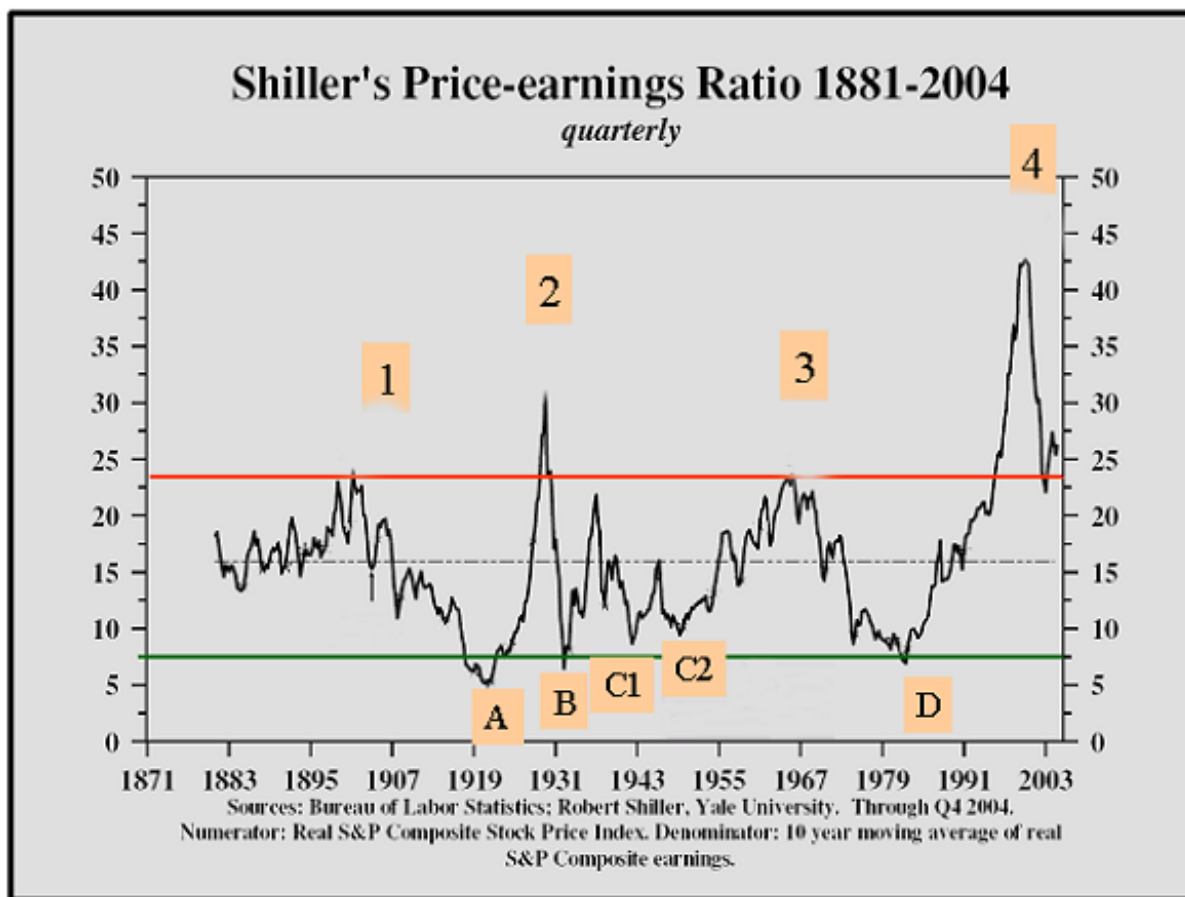


Chart 1

enormous pendulum-like swings indicate that the law of action and reaction for market activity is very much in force. The longer a psychological trend takes to build, the greater the magnitude and duration of the corresponding change in sentiment is in the opposite direction.

To demonstrate this concept I overlaid the numbers and letters from Chart 1 on to Chart 2. It took the 8-year bull market in the 1920's to build up the drunken euphoria that was present at the 1929 top. The actual low was seen three years later in 1932, but the psychological damage, in the sense of people expecting the other shoe to drop, continued for decades. It took about 2½ generations before confidence was fully restored and the market was able to begin the bull trend of the 1980's and 1990's. In terms of prices, it was not until the mid 1950's that the 1929 peak was surpassed. It's also interesting to note that a substantial, and long-

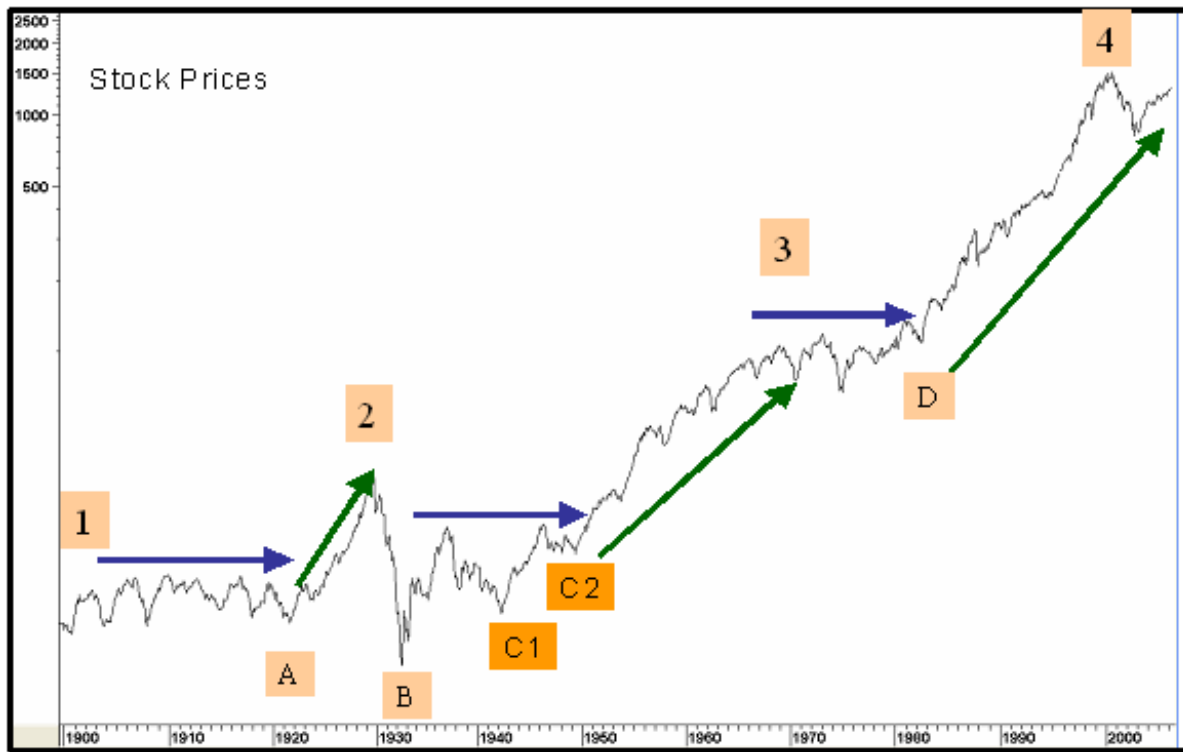


Chart 2

lasting, bull market followed each period when the Price-Earnings Ratio was exceptionally low.

You may be thinking investors got off lightly following peaks 1 and 3, since the market resolved its corrective period with an extended trading range rather than a sharp 1929/32 type decline. However, when equity prices are deflated by commodity prices, we can see the real damage that took place. This is shown in Chart 3, where the numbers and letters from Chart 1 have been overlaid on "real" stock prices.

I'm sure you can now appreciate that the 1900/1921 period was an exceptionally bearish one, especially towards the end. So was the 1966/82 period, although the actual peak in this inflation-adjusted series was 1968. The 1929/49 period is also an interesting analysis. The actual low developed in 1942, although the 1949 bottom was not much higher. In effect, the whole bearish inflation-adjusted trend lasted twenty years, the longest on record. The 2000 peak in the P/E Ratio was the highest, and most distorted on record. If the past is a prelude to

the future, it's unlikely that real stock prices will see the levels attained in 2000 until well into the 2010/20 period.



Chart 3

Finally, the Stock/Commodity Ratio broke below its secular up trendline in May, 2006. There are only five periods when it is possible to construct a meaningful trendline since 1800. This is a very important event because the average drop following a secular trendline break in this Ratio is around 60% and lasts roughly 8 years.

It's a little known fact that there's definite correlation between sentiment and momentum measures, or "oscillators". (To learn more about oscillators, peruse [Momentum Explained, Volume I.](#)) This means we can use the momentum of stock prices as a substitute for sentiment when sentiment data is unavailable. For example, you can see that prices (psychology) have moved too far in one direction

by plotting the annual level of equity prices against a trend deviation indicator. The indicator in this case is a 12-year moving average (MA) divided by a 3-year time span. Charts 4 and 5 display what happens when the data of the two averages are identical; the oscillator is plotted at zero. Since we're using annual data, we're not expecting precise timing, but the indicator's peaks and troughs nevertheless offer useful benchmarks of the market's long-term temperature.

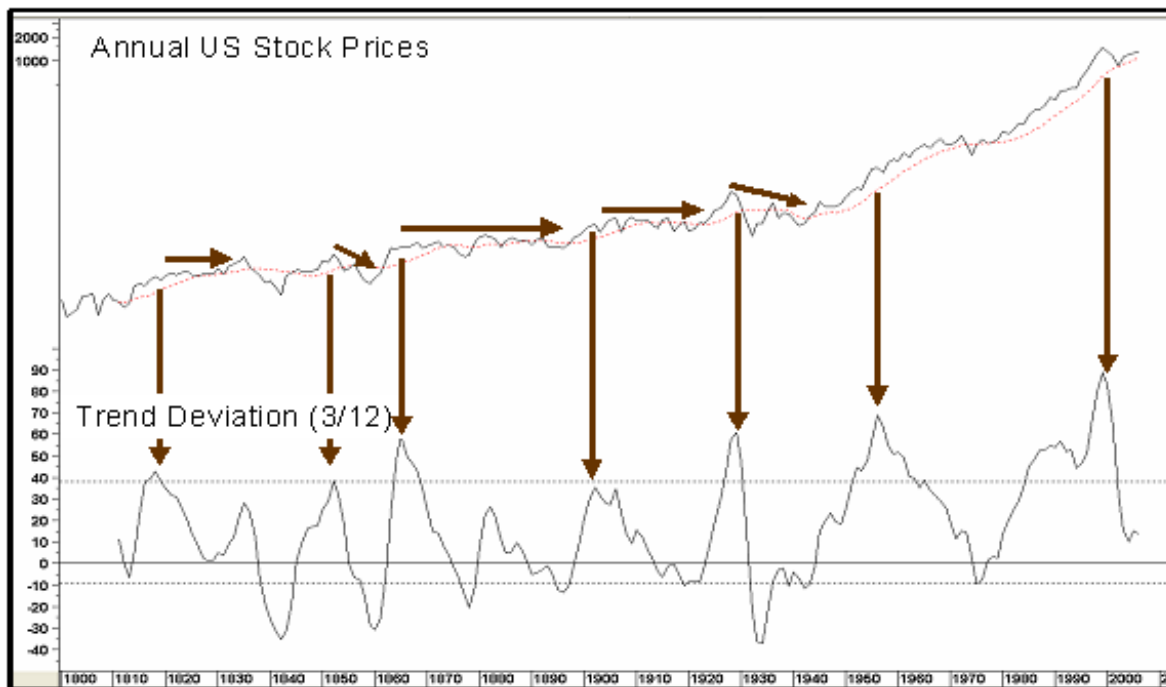


Chart 4

The late 1930's signal proved to be the only one of the nine since 1800 to be a whipsaw. Given that markets spend more time rising than falling, the benchmark has been raised from 10% to 35%, so momentum sell signals are triggered when the oscillator peaks. These sell signals are flagged with the downward pointing arrows in Chart 4. In some instances the peaks are followed by multi-year trading ranges rather than actual declines, but nominal prices still had a hard time advancing after the signal had been given.

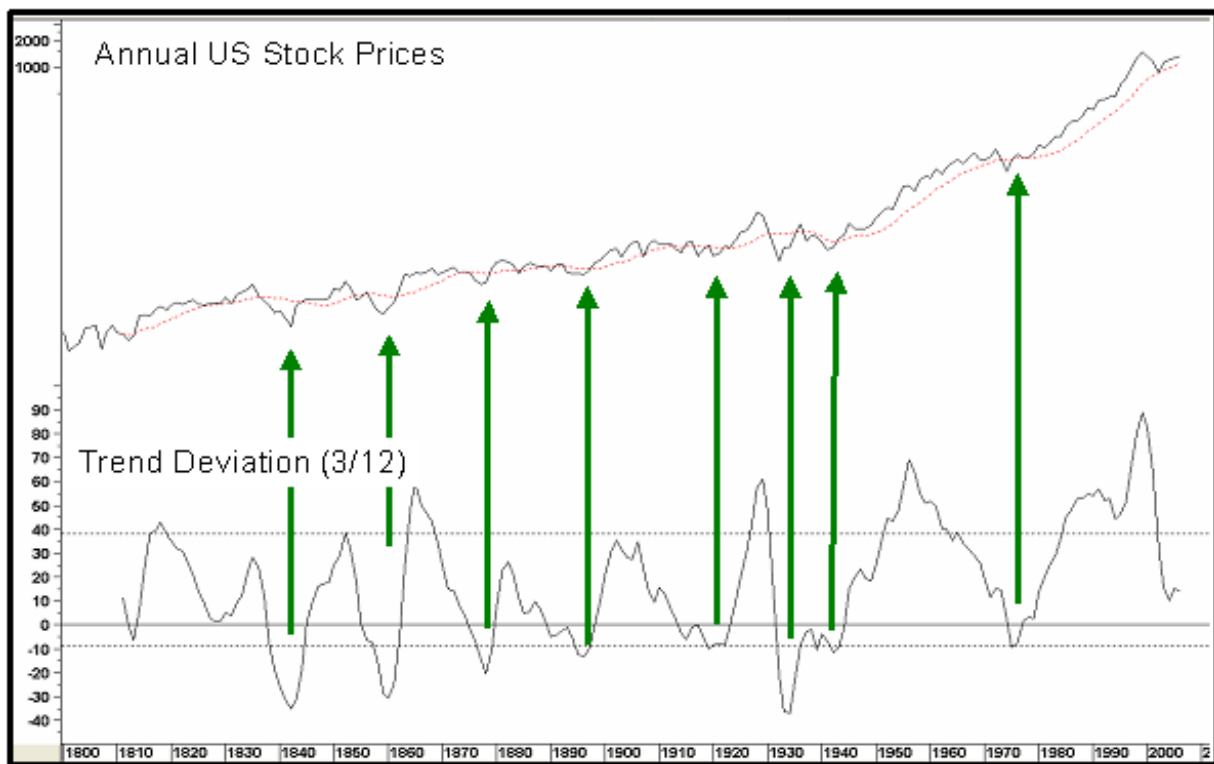


Chart 5 Secular accumulation points are indicated when the oscillator bottoms out from below the -10% level.

Now the Ratio has triggered its seventh sell signal. While it may not be an indication of a major bear market, the oscillator's record certainly suggests that the best the market is likely to do in the 2006/20 period is move sideways in a trading range. Perhaps most importantly of all is what I call the "pendulum principle", which is based on the observation that every sell signal since the early nineteenth century has been followed by an oversold reading before a new secular bull market could get underway. With the indicator still quite a ways above zero, the market clearly has plenty of downside potential before another oversold reading can be generated. In layman's terms, the pendulum still has a long way to swing before investors return to the mood of total disgust with equities that precedes a secular bull market. And this is what brings us to the current picture. (Techniques for identifying reversals in the secular trend of bonds, commodities, and stocks, can be found in [The Investor's Guide to Active Asset Allocation](#).)

The State of the Current Bull

How does the current bull market stack up against previous rallies in a secular bear trend?

There are two big differences between a primary bull market in a secular uptrend and a primary bull market that develops under the backdrop of a secular trading range, or bear market. The “secular uptrend” bull is typically far greater in magnitude and duration, while the “secular downtrend” bull are usually much more subdued. Taking the 1900/21 and 1966/82 periods, the average duration, based on month-end closes, was 27-months for an average gain of 51%. The longest bull market began in 1903 and lasted for 35-months. And the biggest rally, which began in 1907, was followed by a gain of 65%.

The most recent bear market low developed in October 2002, although there was a test in March of 2003, when many other world markets touched their final lows. If we use the October date with an April 2006 high, we come up with a record duration of 42-months for a gain of 61%. If we substitute March 2003 as the low, the duration and magnitude of the rally up to April 2006 was 37-months with a 56% gain, respectively. If the secular bear market or trading range scenario is valid, a cyclical bear market is clearly way overdue, whichever low is used.

Incidentally, the average bear market for both the early- and mid-century periods lasted about 18-months, and prices lost approximately 28% of their value in absolute terms. The average duration was actually a bit longer because the unusually long 59-month decline that took place between 1909 and 1914 was omitted from the calculation. Projecting this average 28% decline would place the S&P Composite at approximately 940 - just below the October 1998 bottom of 966 and almost right at the rally peak separating the late 2002 and early 2003 lows.

The Four-year Cycle

One of the most consistently reliable economic cycles over the last seventy years is the Four-year Cycle. Its premise is that approximately every four years, the market presents us with a major buying opportunity. Normally, the opportunity develops at the end of a bear market, but there have been exceptions such as 1986 and 1998, when the opportunity occurred after a quick decline or extended consolidation. In these instances, the "low" represented a correction in what turned out to be an ongoing bull market. The vertical lines in Chart 6 flag these cycle lows since the 1930's. Sometimes the low occurred at the end of the year preceding the expected low; e.g. 1953, and sometimes a little after; e.g. 1935. This explains why the lines in the chart are not equidistant. The previous four-year low was in 2002, while European markets bottomed in early 2003. That means that cyclically, either this year, or early next, is set to be a low. The chart also shows that in most cases, the market peaks in the year prior to the expected cycle low.

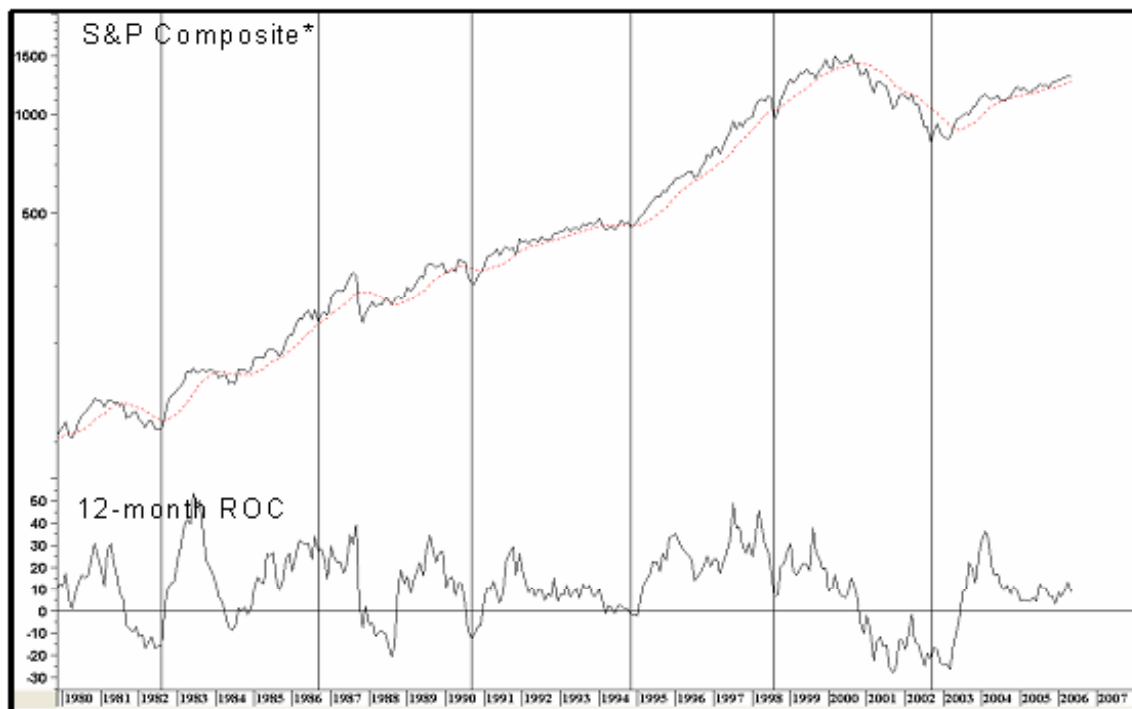


Chart 6 Vertical lines show 4-year cycle lows since 1930's.

In quite a few instances though, when the market tops out in the same year, the decline is short, quite sharp, and invariably unexpected. This scenario took place in 1946, 1990, and 1998, although 1986 was the exception.

The Typical Stock Market Cycle

The four-year business cycle has been reliably tracked since the beginning of the 19th century, when statistical data first became available to track it, cycling through a [set series of chronological sequences](#) beginning with an improvement in the financial indicators. The process continues with a revival of leading interest-sensitive indicators such as housing right through to lagging sectors such as capital spending. The financial markets (bonds, stocks, and commodities) also form part of this sequence. Figure 1 displays how the various components have *usually* peaked and troughed throughout its 200-year history.

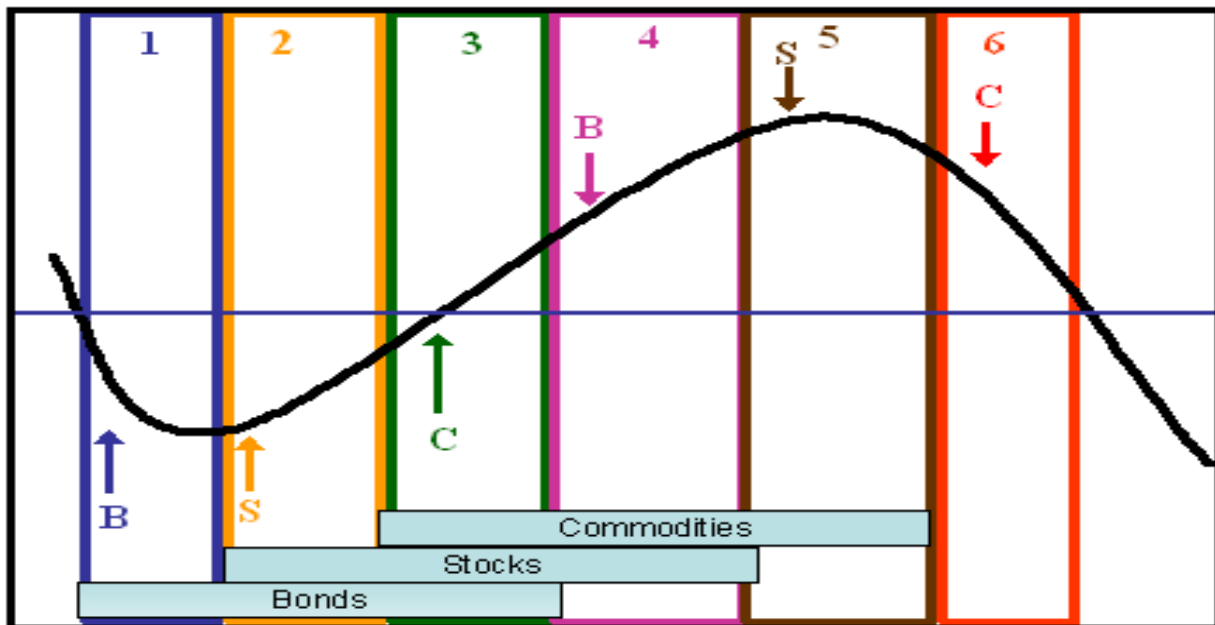


Figure 1

The sine curve represents the path of economic growth or contraction, and the horizontal lines separate expansionary periods from contractionary ones. Because historically, an economy undergoes a chronological sequence of events during a complete cycle, it's possible to identify turning points for various financial and economic indicators as well as bonds, stocks, and commodities. Figure 1 shows the idealized periods for the three financial markets; bonds, stocks, and commodities. The financial market sequence usually develops without fail, even when the growth path reverses from above zero as it did in the 1960's, 1980's and 1990's. The major difference between these "growth recessions" and actual economic contractions is that there is usually less volatility within the three markets. (These topics are discussed at great length in, [The Investor's Guide to Active Asset Allocation](#).)

I have taken this concept a step farther by breaking the three cycles into six definable stages since the three markets each have two turning points. The bullish stages have been flagged in Figure 1 with the rectangular boxes. Stages II-IV are bullish for stocks, but when the cycle enters Stage V, it's time to anticipate a primary trend peak. My consensus model, or "Barometers" are comprised of

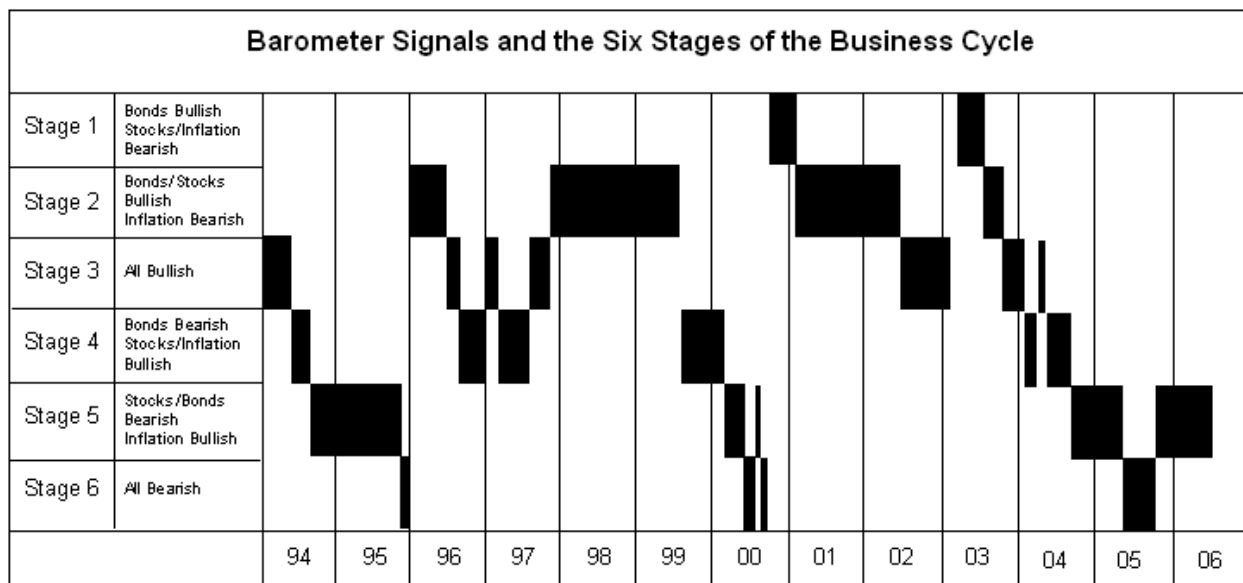


Figure 2

economic, monetary, and technical indicators monitoring the status of each market, and emphasize whether the background factors are bullish or bearish for a particular market.

As with any technical indicator though, markets don't always respond to the environment in the expected way. This is especially true for stocks, which are more susceptible to psychological mood swings than the other economically driven markets. The Stock Barometer went bearish in the summer of 2004 (see Chart 7). Since then, the market has rallied of course, but this is not uncommon, as stocks have often eked out a small gain during the months immediately following the bearish signals. However, as long as the Barometer remains in a bearish mode, the overall risk/reward is not favorable, as can be seen with the 1969, 1974, and 1987 periods. (The stock commodity, and bond Barometer, are updated and analyzed in our monthly newsletter, [The InterMarket Review](#). Figure 2 shows our current location within the 6 stages as of the June *InterMarket Review*.)

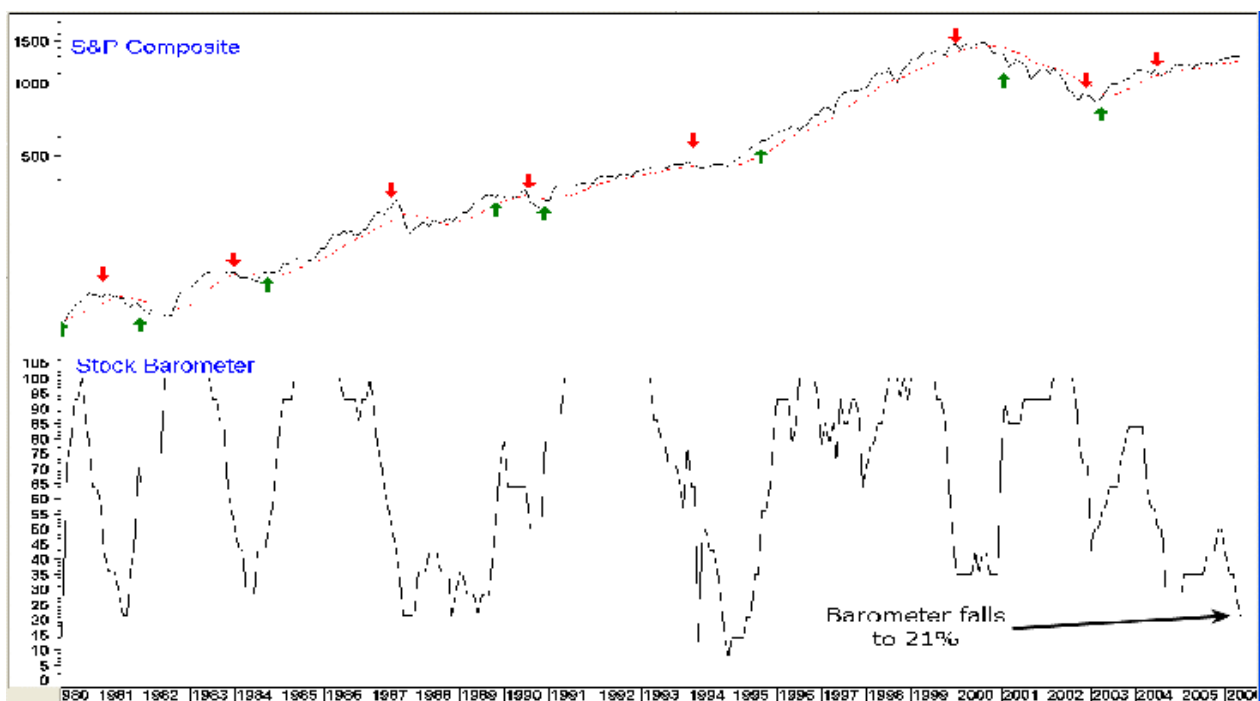


Chart 7

Arrows show when the Barometer crosses 50%.

The Monetary Background

I've always believed that the "rate-of-change" (ROC) of interest rates is more important than the actual level of interest rates. If levels are so important, how can one explain the extreme economic weakness in the 1930's when rates were in the basement compared to relative prosperity in the 1970's and 1980's when rates were in the stratosphere?

To prove this point, Chart 8 compares the annual change in the level of the Discount Rate to the S&P Composite. The vertical lines show that when the ROC initially moves up to the +30% level, this almost invariably spells trouble for equities. The only exception we can find going back to 1919 is the 1995 experience when equities totally ignored rises in short-term interest rates. The latest signal developed in mid-2004, so even if prices declined from here it could not be regarded as a particularly timely one. However, the main point of this exercise is that it's still flashing danger for equities, because when rates rise at an exceptionally fast clip, the economy weakens and stocks sell off in anticipation.

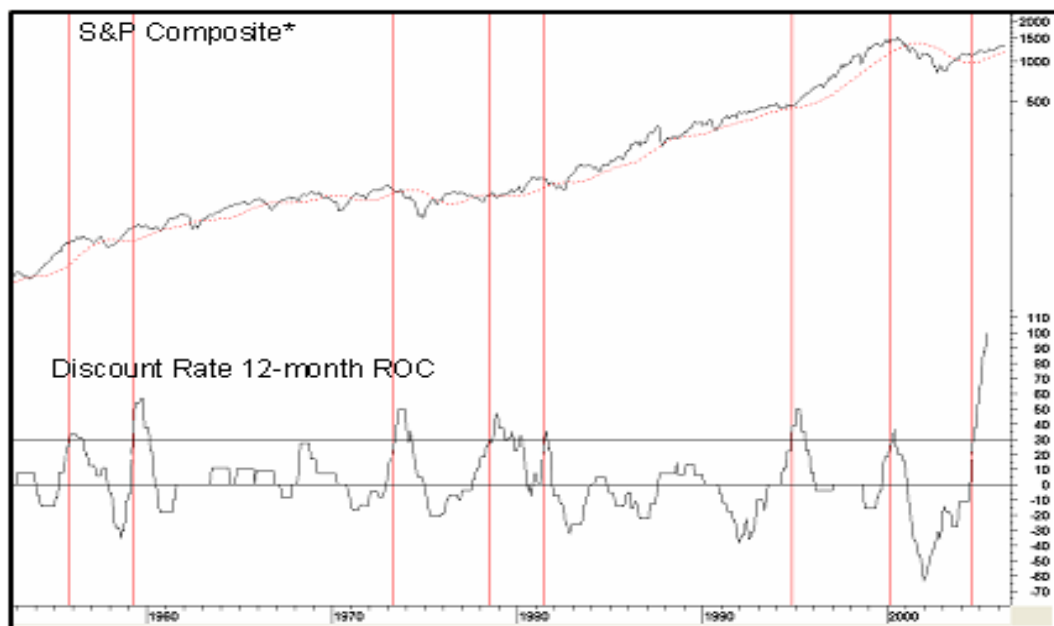


Chart 8

Another technique you can use is to compare the total return on stocks less the total return on 3-month Commercial Paper to find out when the rise or decline in

rates is starting to affect equities. A version of this indicator has been plotted in the middle panel of Chart 9.

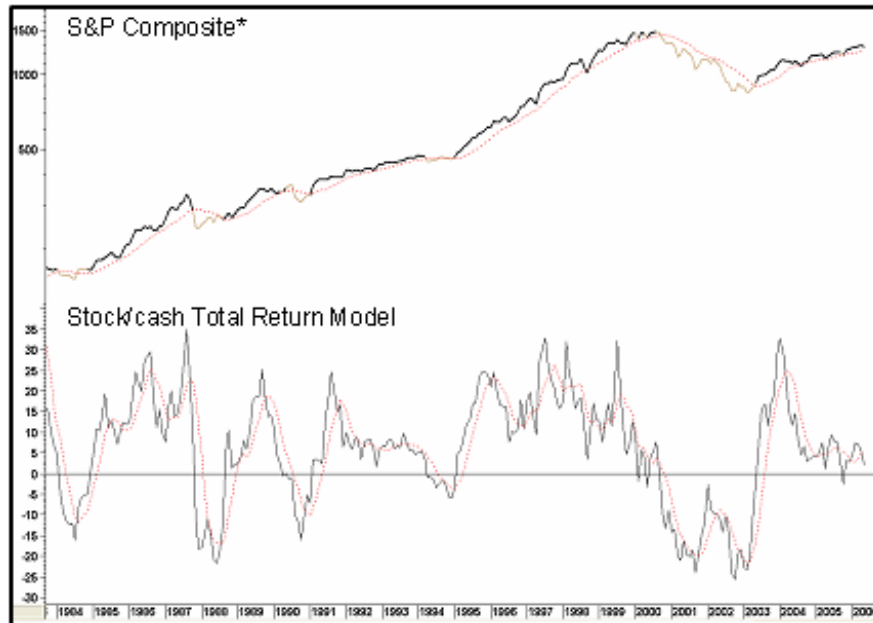


Chart 9

A sell signal is given when the indicator moves below zero because it implies the rate of return on cash is about to exceed the rate of return of stocks. The indicator is currently bullish, but is clearly not far from a negative signal.

Key Intermarket Relationships

Stocks vs. Commodities

In Stages III and IV (see Figure 1) stocks and commodities are both rising. There are few distortions during this mid-cycle phase because commodities are not advancing with a vengeance, which reflects an improving economy. This, in turn, allows equities to thrive because they're able to look forward to a healthy growth in

profits. After a while, the economy picks up steam so commodity prices advance at a faster pace, triggering acceleration in the upward trend in interest rates. Stock market participants now begin to sense these pressures will eventually result in an economic slowdown, or actual recession, so they cull profits, and become more cautious. This results in a loss of upside momentum in equity prices, causing the balance to tip to the deflationary side, and the ratio of stocks to commodities peaks out.

Chart 10 shows this relationship. The arrows mark the chart points where the [KST](#), or smoothed momentum, peaks out.

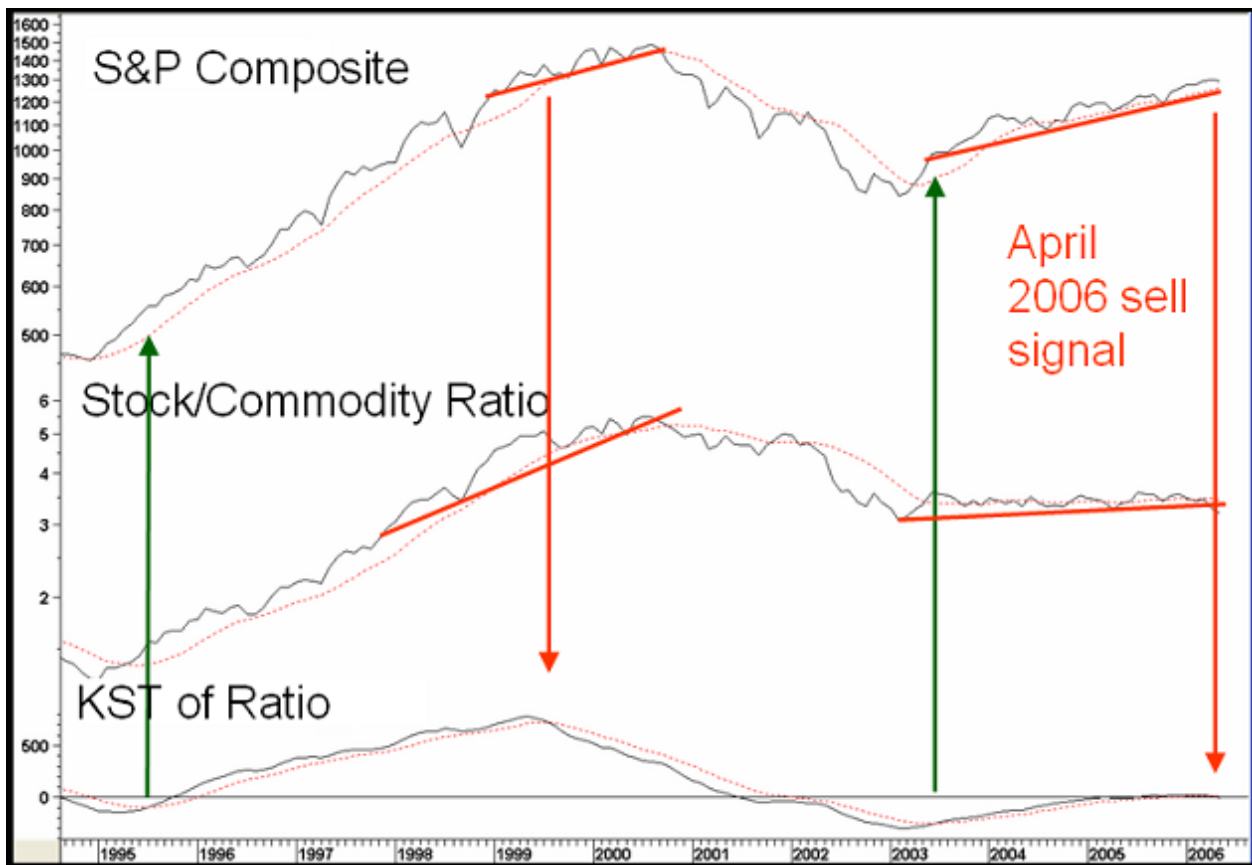


Chart 10

The chart also emphasizes that during the 2002-200? S&P bull market the commodity adjusted S&P Composite only managed to experience a sideways

trading range. This in itself is a clear indication that a secular peak was reached in 2000. It has since broken to a post 2000 low in May and violated its secular up trendline (Chart 11).

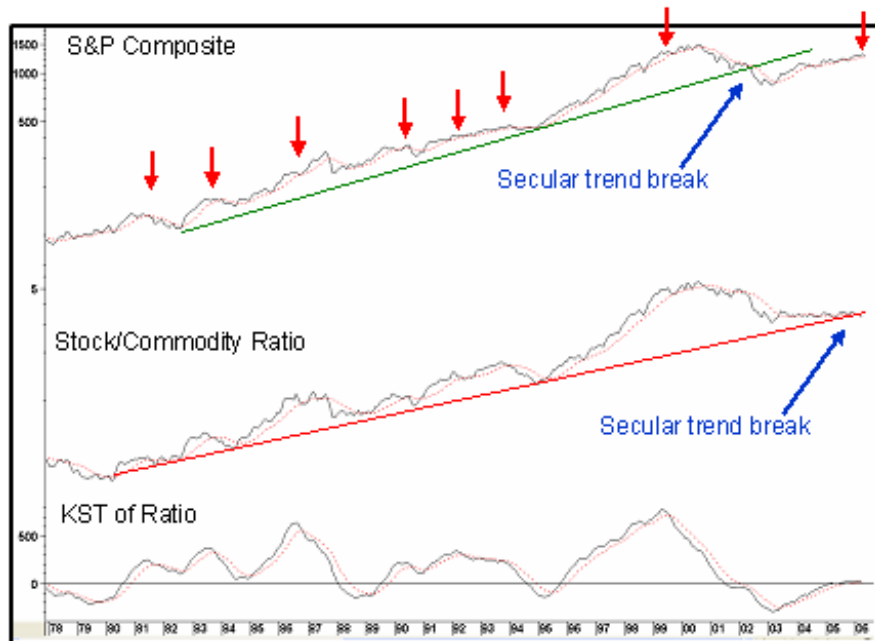


Chart 11

This is an extremely serious technical breakdown and offers further evidence that a secular peak was seen in 2000. This is one of the longest secular breaks in the last 200-years and if the average drop in real prices from previous violations is achieved, this would send prices back to the “real” levels last seen at the 1994 low. (This relationship is discussed at length, together with its performance since the mid 1950’s in, [The Investor’s Guide to Active Asset Allocation](#).)

Because the Consumer Price Index (CPI) is less volatile than commodity prices CPI, adjusted equity prices have been in an uptrend since 2002 (Chart 12), even though the secular trend break and the consistently accurate sell signals from

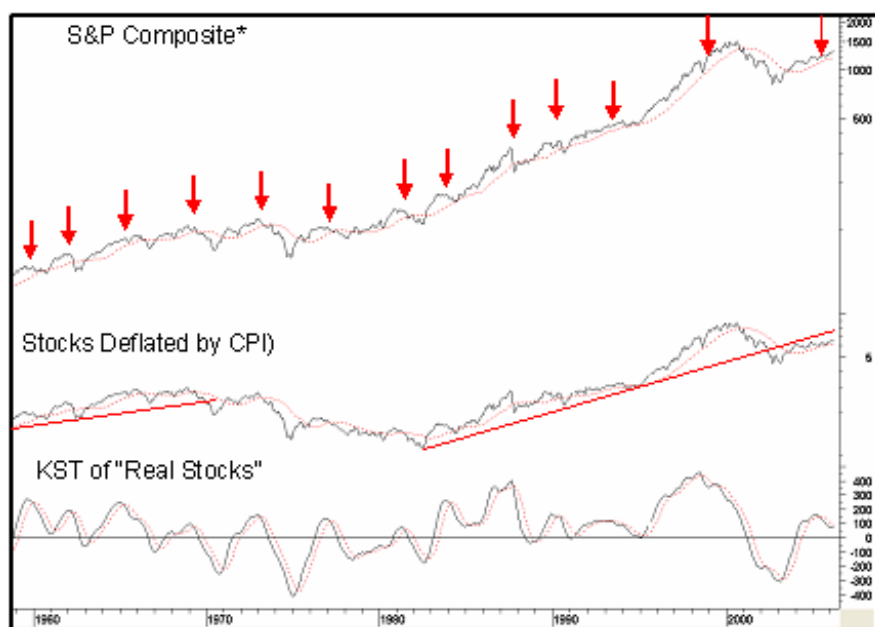


Chart 12

peaking KST of this relationship are still very apparent. If you look at the historical chart (not shown) that covers the period prior to the 1960's, you will see that apart from the 1924 signal, reversals in this indicator from above zero have consistently forecasted primary bear markets on a very timely basis, with the most recent signal developing in April 2004. So based on past relationships, we should expect a stock market peak at any time. At the end of May 2006, the ratio had also experienced a marginal bull market trendline break but remained just above its 12-month MA (not shown).

Stocks vs. Gold

Trend reversals in the Stock/Gold Ratio also warn of an impending U-turn in equities. These signals are not triggered very often, but when they are, it's a good idea to pay attention. Gold prices typically lead commodities at both tops and bottoms, so it's not surprising this Ratio is an excellent forecasting tool for equities.

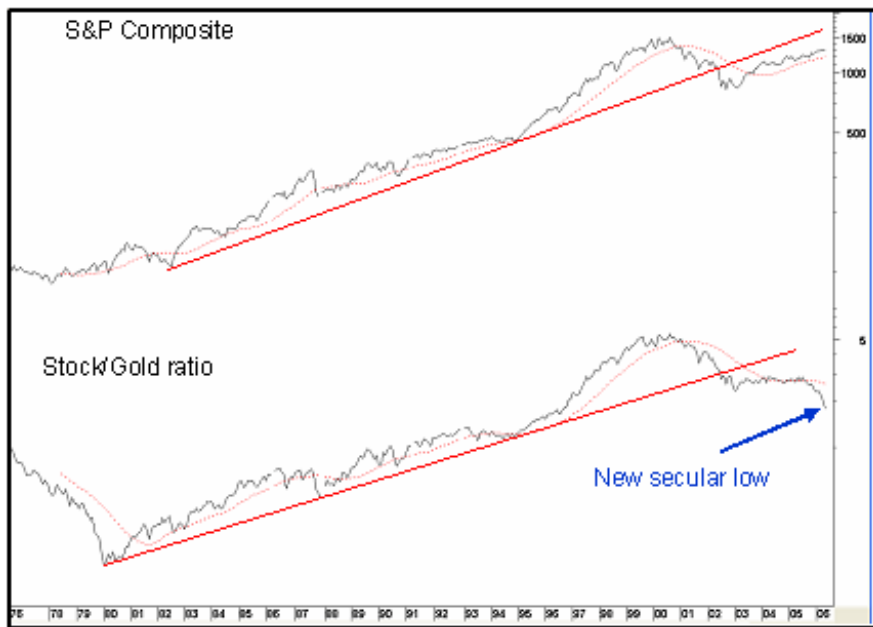


Chart 13

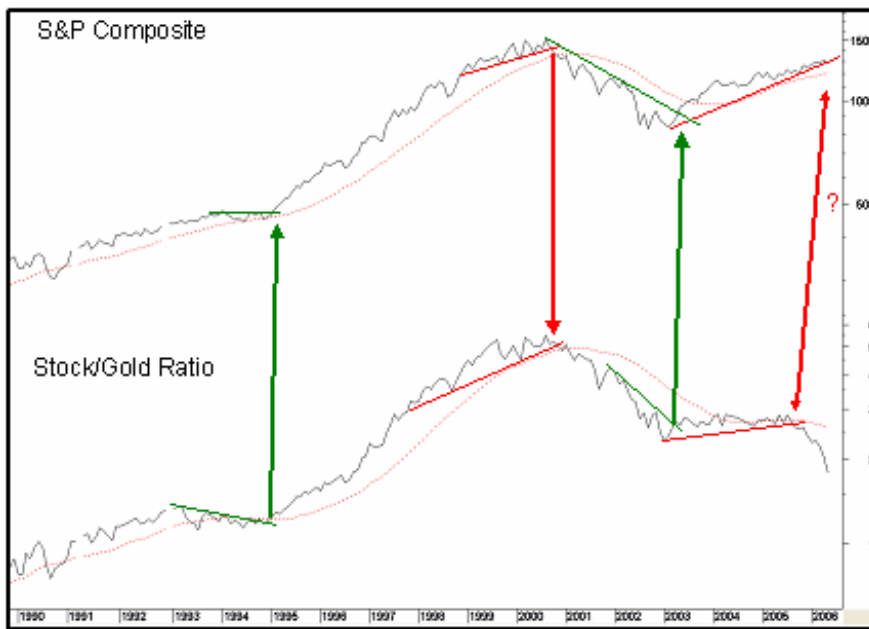


Chart 14

Chart 13 shows the secular trendlines for both the ratio and the S&P were violated a few years ago and it's possible to construct trendlines for both series on Chart 14. When they are jointly violated, a reliable trend reversal signal is given.

The ratio is already at a new cyclical and secular low, which is a very ominous sign from a long-term perspective. Confirmation of this ratio break will come when the S&P Composite itself violates its (end-of-month) up trendline at 1260.

The NASDAQ 100 vs. the Dow

The ratio between the NASDAQ 100 and the Dow has offered timely market signals over the past fifteen years (Chart 15).

The Dow consists of many different stocks, but on balance, they tend to be defensive, high yielding blue chips, while the NASDAQ 100 equities are growth-oriented. This means that when the NASDAQ is out performing the Dow, investors are optimistic and tend to push up equity prices in general. On the other hand, a falling ratio means sentiment has turned more cautious, which is negative for the market.

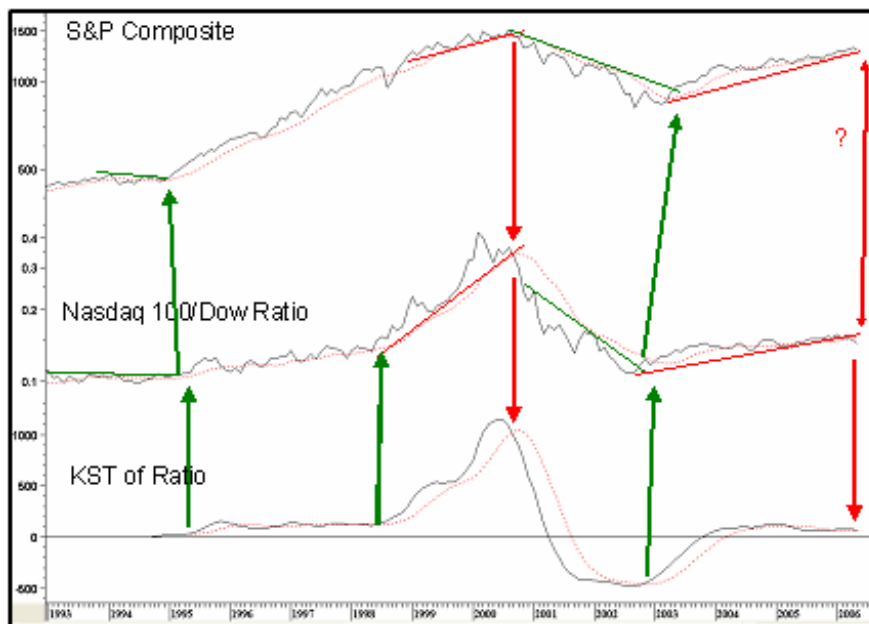


Chart 15

Trendline violations and decisive KST reversals have often been followed by major reversals in both the ratio and the market. The only period when the ratio experienced anemic price action was between 1996 and 1997, but at that time there were no trendline violations to back up the signals. That's certainly not true of the current situation, as the ratio has broken below an up trendline and its 12-month MA. In addition, the KST is also in a bearish mode, so consequently, the brief history of this relationship adds more fuel to the proverbial bearish fire that the whole market is likely to experience a major decline.

Leading Market Sectors and Divergences

We have already established that bond prices lead equity prices. For this reason, market sectors that are sensitive to interest rate changes often provide advance warning of impending trouble. One well-known relationship is the relationship between the S&P and the Dow Jones Utility Average, shown in Chart 16.

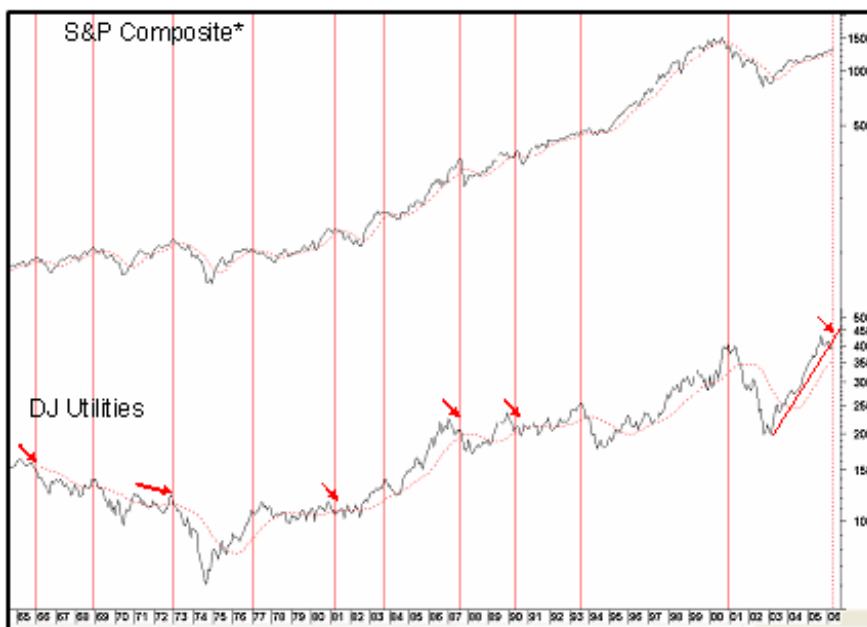


Chart 16

The vertical lines flag the bull market highs in the S&P. On most occasions the Utilities give us a warning by peaking ahead of the S&P, but sometimes that is not the case. For instance, in 1977 and again in 1994, the Utilities lagged the S&P. This didn't make the situation any less bearish, just that Utilities didn't offer their usual warning. This time, they peaked in September of 2005, well ahead of the high for the S&P, which was set in April 2006. Fair warning this time!

The relationship of Homebuilders, another interest-sensitive sector, is shown in Chart 17 along with the S&P Composite. In most situations, the S&P Homebuilders peak well ahead of the S&P. Chart 18 shows this relationship back to its inception in 1966 as well as introducing the relationship's relative action.

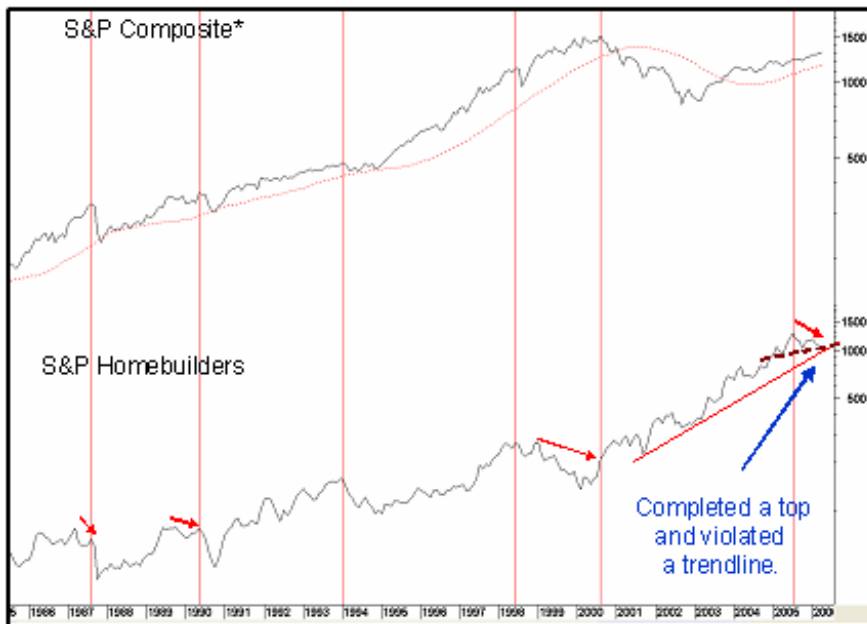


Chart 17

An additional warning to the market, in general, is shown in Chart 18, when the Homebuilders coincide or lag the S&P, the RS line typically has a sharp sell off. In the current situation, the Homebuilders have not only completed a top, and decisively violated a major up trendline, but the sharply falling RS line is below its 18-month MA. This relationship doesn't tell us the S&P is about to decline but, like

the utility divergence, warns us that the market is now extremely vulnerable. Consequently, when the S&P violates its 12-month MA, the weakness in these two indicators will be confirmed.

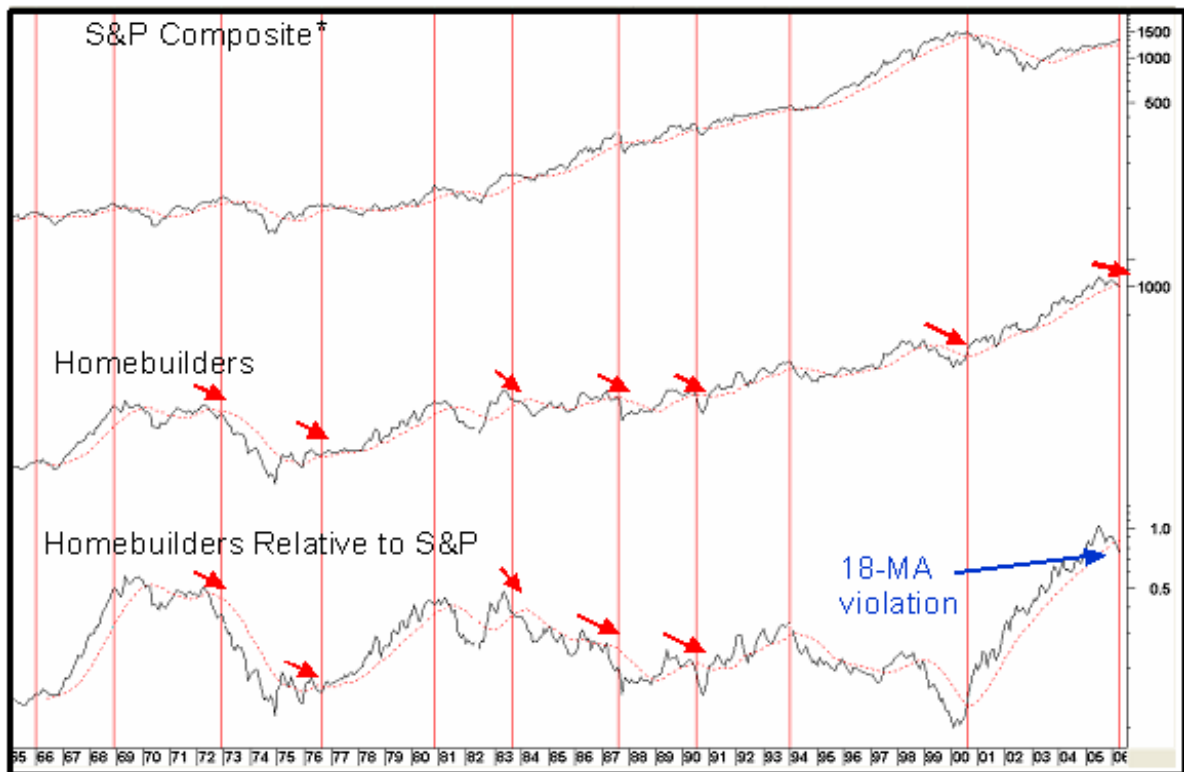


Chart 18

Finally, market peaks are often preceded by weakness in the breadth data along with numerous other negative divergences. The April peak did experience some small-time divergences with the NYSE A/D Line, but nothing of primary trend significance. However, Chart 19 does show there were numerous negative divergences (flagged by the red arrows) between the S&P, Short-term KST, 39-week ROC, and the NYSE NYSE Net New Highs. Notice the final rally at F was extremely weak for the KST. This means when the S&P confirms with a break below the trendline and 65-week EMA, a sharp decline is likely to follow. In mid-June 2006, the line and the 65-week EMA were around 1245.



Chart 19

Summary –

1. Secular trends in equity prices are determined by multi-decade swings in sentiment, as investors move from a generational swing in pessimism to the overconfident and “irrational exuberance” at peaks.
2. History tells us that once an extreme in optimism has been reached, it takes a very long time, decades, in fact, for the pendulum to move to the other extreme.
3. Our indicators advocate that a secular peak was seen in the year 2000.
4. These types of secular market turning points have always been followed by massive bear markets like the one that developed in 1929, or multi-year trading ranges as witnessed in the 1900/21 and 1966/81 periods.
5. *Without exception*, stock prices, when adjusted for inflation, experienced a significant loss in purchasing power following previous long-term tops.

If our assumption regarding the secular peak is correct, then the current bull market, based on previous counter-secular rallies, is extremely long in the tooth. Moreover, since a four-year cycle low is due in 2006, it's probable the market will now play catch-up on the downside. The evidence, whether it comes from monetary aspects, financial market sequences, or intermarket analysis, is strongly bearish. If we use valuation measures, such as Shiller's Price Earnings Ratio (26 on 12/05), or even the paltry 1.85% yield on the S&P as a sentiment indicator, long-term optimism is still very much in vogue, continuing to point to the fact that the market is vulnerable.

Talking of optimism, look at the recent *Barron's* cover story that developed just one week prior to the top. I must add that *Barron's* doesn't have a reputation as a contrary indicator like, *Time*, *Newsweek*, *The Economist*, or *Business Week*, but the consensus optimism of money managers is too significant to be ignored.

BARRON'S COVER

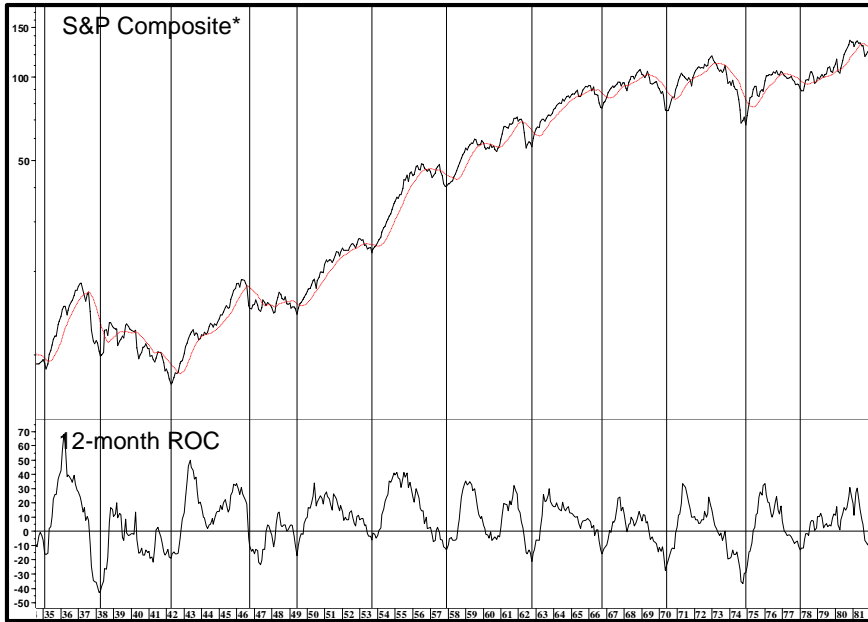
Headed for Dow 12,000 by Jack Willoughby



More than half of the participants in the latest *Barron's* Big Money poll are bullish about the stock market's prospects through the end of this year -- despite \$70 oil, rising bond yields and sky-high gold prices. Granted, bargains are tougher to find, but they're still there. Hint: Try the tech sector.

One thing that has not yet happened is a break by the S&P below its 12-month MA, a benchmark that often reliably confirms major trend reversals. As I mentioned earlier, the average is expected to be around 1255 at the end of June. Normally, I like to see this average breached. Not that it has a perfect record, but negative crossovers usually offer reliable signals that the bear has returned. With so many other indicators pointing south though, it will be surprising if the market does follow suit for the remainder of 2006.

If this article has piqued your curiosity for more information and you would like to receive regular updates on this type of in-depth information please take a look at our monthly *InterMarket Review* and website – <http://www.pring.com/>, where all these indicators and much more are monitored on a monthly basis. The current June copy is there for you to download and peruse at your leisure. You'll also find a bevy of articles, educational movies, and online charting, all **FREE!** ■



* Vertical lines show four year cycle lows

[Click here to go back to original](#)

Chart 6a



Chart 1a

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